

# Project Notes

## **Municipal Accounting and Financial Reporting Standards in India**

### ***Promoting Reform at Both Policy and Practitioner Levels***

*As cities in India turn to capital markets and the private financial sector to finance urban environmental infrastructure, the need for reform of finance and accounting practices at the local level has become apparent. Transparent financial information and standardized accounting practices not only enable more effective governance, but they form the foundation of municipal credit ratings. In response to this need, the FIRE(D) Project is working at local, state and national levels, with both policy-makers and practitioners, to reform accounting standards and develop uniform financial reporting standards in India. This Project Note describes these efforts and issues that have emerged in the process.*

#### **The Need for Accounting Standards and Uniform Financial Reporting**

In India today, financial reporting by urban local bodies consists of very simple single-entry cash based systems of reporting against budgetary outlays. While these systems do conform to state or city level legislative requirements, they are increasingly recognized as insufficient.

Though the two basic purposes of financial reporting by any entity are to provide information regarding the status of its financial performance and status of its financial position, current practices do not serve either purpose.

Likewise, completeness and accuracy of accounting data is an important principle of financial reporting. Yet the current accounting systems and practices neither record financial information completely nor do they guarantee the accuracy of this information.

Accounting standards provide uniform treatment and disclosure of accounting for important account heads such as depreciation, inventory and revenue recognition. Currently, however, there are no established accounting standards upon which uniform financial reporting can be based nor a technical guide on how to apply the standards for local bodies in India.

#### **Initiating Reform at the National Level**

Recognizing the need for reform, the FIRE(D) Project approached the Institute of Chartered Accountants of India (ICAI), India's premier accounting body which, among other things, establishes accounting standards for all business entities in India. At the same time, this initiative was supported by a request from the Union Ministry of Urban Affairs and Employment to develop a model accounting system for local bodies. ICAI immediately took the lead and created a study group to develop a technical guide with the support of the FIRE(D) Project.

In a country as large as India, with statutory requirements that vary greatly from state to state, it is difficult to address all accounting and reporting issues. However, ICAI is currently reviewing all known issues and matters relating to such bodies for incorporation into the technical guide. The guide will subsequently have to be adopted and adapted by state governments for application to local bodies. It may also be worthwhile for ICAI to publish a periodical to provide information regarding pertinent financial management and accounting topics to state legislative bodies and to local governments.

The need for such principles and standards was also cited by the Securities Exchange Board of India (SEBI) in its approval of the Ahmedabad municipal bond issue. The Board considered the city's accounts and financial statements, which are not based on Generally Accepted Accounting Principles (GAAP), as a risk to investors to be disclosed in the prospectus of the issue. To address this problem, the technical guide will describe principles of accounting and financial reporting for urban local bodies, keeping in mind accounting characteristics of various governmental funds such as fiduciary and proprietary funds.

### **Working for Reform at the State and Local Levels**

At the local level, a number of cities have taken steps to reform accounting systems. For example, in 1990, the World Bank provided support to six cities in the state of Gujarat — Ahmedabad, Baroda, Surat, Rajkot, Bhavnagar and Jamnagar — to improve accounting systems. Different firms of public accountancy were engaged to develop improved systems and manuals for these cities, which were left to the respective cities for implementation. While the experiences of these cities have varied, most are still working to produce financial statements after a period of eight years. The FIRE(D) Project conducted a detailed study of the results of the World Bank efforts in Ahmedabad, and its findings have been provided to the ICAI study group to assist in its work.

At the state level, Tamil Nadu has taken the lead in preparing a revised accounting manual for all local bodies, which will then support the introduction of a computerized double entry accrual based accounting system. Both the FIRE(D) Project and ICAI are assisting in this effort, and a software company has been engaged by the Tamil Nadu Urban Development Fund to develop accounting software based on the revised manual.

### **Financial Information:**

#### **The Foundation of a Municipal Credit Rating**

The FIRE(D) Project then turned to credit rating agencies and financial institutions and asked that they identify current constraints to evaluating the financial status of local bodies. According to Credit Rating and Information Services of India Limited (CRISIL), based on its experience rating the credit of local bodies, some of the most basic information is relatively inaccessible, such as:

*Revenue Receipts.* This includes estimates of slippage of octroi; cash in transit and cheques under transfer; demands raised under the current property tax cycle; duration of arrears; arrears under transfer of revenue grants; and revenue break up for various consumer segments.

*Revenue Expenditures.* This includes information such as expenditure classifications for each core service such as water supply, public health or solid waste management; amount payable on expenditure accounts; and interest accrued and due or not due.

*Capital Receipts.* This includes proper classification of state government loans and state government grants, and identification of receipts and utilization of project specific loan funds. Projected and actual drawdown schedule of loans must also be identified, as well as proceeds from the sale of assets.

*Capital Expenditures.* This includes project-specific accounting of major capital works. Accounts should show original estimates, revised estimates (cost escalation), amounts actually incurred for a specific project, actual repayment of state government loans, and appropriation of revenue expenditure on capital works (capitalization of expenses).

*Performance Indicators.* Important information such as key indicators is not available at all through current systems. Key performance indicators include details of existing capacity for water treatment and water storage, hospital beds and patients treated, waste handling capacity, frequency of road resurfacing, per unit O&M or indirect cost of output for treated water, student enrollment and the operating status of capital works.

Overall information deficiencies also exist. Intra-budgetary transfers and undisbursed or un-utilized budgetary provisions are shown as opening balances for the next fiscal year. Likewise, there is no clarity on un-utilised funds, such

as the transfer of surplus in the revenue account to capital expenditures, or deposits or advances received for specific projects. Information and reporting systems are inadequate, causing delays in the finalisation of accounts, and there is a lack of efficient audits.

### **The Perspective of Financial Institutions**

Similarly, financial institutions have identified systemic constraints which must be addressed. These fall in three main areas.

*Single Entry, Cash Basis Systems.* One chief constraint is the fact that provisions of Municipal Acts regarding the maintenance and auditing of accounts are not specific enough to effectively maintain a double entry accrual basis of accounts. The resulting single entry, cash basis system does not provide information required to determine the financial performance of municipal bodies or to provide for an accurate comparison with other municipal bodies.

*Human Resources.* In addition, the level of competency of current human resources is inadequate for introducing and maintaining a double entry system of accounts. Moreover, accounting personnel at the local level are typically clerks who are frequently transferred among departments over the course of their careers. This practice has the infortunate effect of inhibiting their ability to specialize in accounting.

*Non-Transparent Policies.* The view presented in a local body's financial statements, regarding its financial state of affairs and its surplus or deficit, can be significantly affected by the accounting policies followed in the preparation and presentation of those financial statements. The disclosure of significant accounting policies is necessary if the view presented is to be properly appreciated. Currently, however, accounting policies are not spelled out by municipal bodies in the presentation of their accounts. For this reason, there is no uniformity among presentations. Also, fixed assets registers are not maintained since they are not mandatory and depreciation is usually not accounted for.

### **Developing a Technical Guide**

ICAI, with the assistance of the FIRE(D) Project, is committed to developing a technical guide<sup>1</sup> for urban local bod-

ies that clearly reflects three main objectives. First, financial reporting must be based on the accrual basis of accounting. Second, financial accounting and reporting must conform to accepted accounting standards and policies, based on the standards that are developed. And finally, accounts of local bodies must be audited by independent and external auditors.

In support of this effort, the FIRE(D) Project is working with the ICAI study group to provide manuals and background material on governmental accounting standards and financial reporting developed by local bodies within India as well as overseas. FIRE(D) has also worked with members of the study group to provide exposure to municipal standards and financial reporting in the United States.

The technical guide under preparation will include a number of recommendations to meet the expectations of various user groups.

*Generally Accepting Accounting Principles.* Standard and model financial reporting formats for urban local bodies must be based on generally accepted accounting principles (GAAP). The technical guide will provide guidance on the development of "notes to accounts," compilation of accounts, and development of appropriate accounting policies in the areas of grants, depreciation, treatment of retirement benefits, valuation of inventory and fixed assets. It will also provide guidance on development of opening balance sheets to transition from the present single entry to a double entry accounting system.

*Fund Accounting.* Guidance on governmental fund accounting, to be based on a set of separate self balancing accounts or funds to track revenues and expenditures, will be provided. This will allow financial managers and other decision makers to plan and budget their finances effectively and also allow detailed and accurate analysis.

*Public Utilities.* The technical guide will also address public utilities in all service areas, to assist municipal staff, outside bodies and professionals to understand their accounting and reporting requirements.

*Auditing.* The technical guide will address audit techniques unique to local bodies and recommend that financial health be assessed through both internal and external audits.

<sup>1</sup> The ICAI published a technical guide on accounting and financial reporting by urban local bodies in October 2000.

*Government Accounting Standards Board.* The technical guide will provide recommendations for creating a board similar to the Government Accounting Standards Board in the United States for the purpose of issuing governmental accounting standards.

*Adaptation by States.* Though the technical guide aims to achieve a uniformity of approach, it will also allow flexibility in certain areas due to local conditions or statutory requirements. Recommendations are expected to be adapted to local conditions and approved for implementation by each state legislature. To facilitate this process, ICAI will sponsor a number of workshops, conferences and continuing education programs. The Housing and Urban Development Corporation (HUDCO) has also offered to adopt one pilot city and assist in the implementation of the recommendations.

### Conclusion

Ultimately, the adoption and implementation of the technical guide will provide local bodies with more accurate and complete financial information, which will help improve governance and, in particular, the delivery of services, resource mobilization and utilization of scarce financial resources.

From the states' perspective, it will provide better financial information upon which to base performance-linked grants, and it will enable states to better oversee local administration. Adoption of the guidelines will provide financial institutions with the necessary financial information on a more timely basis upon which to consider requests from local bodies for investments in urban infrastructure. And credit rating agencies will be better able to rate the credit of local bodies on a timely and cost effective basis.

Finally, improved accounting and financial reporting will allow for more accurate and complete intra-state and inter-state financial comparison among local bodies. Ultimately, this will assist states and the central government in developing and implementing policies and programs for local bodies.

*This Project Note was written by G.P. Singh, Financial Management Advisor to the FIRE(D) Project.*

The mission of the Indo-US FIRE (D) Project is to foster the development of a commercially viable urban infrastructure finance system to finance improvements in environmental services for all citizens, including the urban poor. It is being implemented through four objectives.

- Development of commercially viable urban environmental infrastructure projects in selected demonstration cities;
- Development of a commercially viable urban environmental infrastructure finance system;
- Improvement of municipal financial management as well as the administration of environmental services in demonstration cities;
- Strengthening the capacity of public and private sector professionals and technicians to achieve these objectives.

Commercial viability requires the careful analysis of municipal investment capacity within a broad urban finance framework; identifiable revenue streams and adequate return on investments; and risk allocation and mitigation. In addition, private sector participation can improve efficiency and introduce new technologies for delivery of urban environmental services.

This new approach to providing urban environmental infrastructure and services enables Indian cities and urban authorities to respond more effectively to the greatest needs: increasing access to services and improving service levels and quality, as well as meeting demand, particularly among the most disadvantaged.

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Funded under USAID Contract No.  
386-0531-C-00-5027-00

The *Project Notes* series is edited and produced by Laurie de Freese.